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SUBJECT: LATVIA PASSES BUDGET BUT ECONOMIC TROUBLE REMAINS

REF: A. RIGA 569, B. RIGA 542

¶1. (SBU) Summary: Latvia's parliament approved the 2010 budget on December 1, clearing a significant hurdle to Latvia's economic recovery. The budget has been welcomed by the IMF and EC, which will begin negotiations on the second review of the Stand-by Agreement on December 2. The budget vote was met by a couple of minor peaceful protests by students and trade unionists. Despite the budget passage, the general economic picture remains weak and will continue to deteriorate through at least the first half of 2010. End summary.

#### Budget Passes

¶2. (SBU) Latvia's parliament (Saeima) approved the 2010 budget in a party-line, late-night vote of 64-30, with 2 abstentions, on December 1. The final budget was different from the budget that passed in the first reading on November 5, but lacked any real surprises. The major changes were all hashed out over the course of the past few weeks in intense behind-the-scenes deliberations between the IMF/EC and the Cabinet of Ministers, which pulled the budget into compliance with Latvia's international financial assistance package obligations. The IMF and EC issued coordinated statements welcoming the agreed budget on November 27. The negotiated changes include the introduction of a small progressive real estate tax, an increase in the personal income tax rate to 26%, and excise taxes on natural gas, cigarettes and alcohol.

¶3. (SBU) The budget includes LVL 500 million (USD 1.068 billion) in fiscal adjustment, including LVL 244.5 million (USD 522 million) in expenditure cuts and LVL 255.5 million (USD 545 million) in projected tax and non-tax revenue increases. These measures represent roughly 4% of GDP. The 2009 budget deficit is still anticipated to hit 10% of GDP, but the Latvian government believes the just passed 2010 budget will result in a deficit of only 7.6% of GDP in 2010, which is well below their EC memorandum target of 8.5%. Whether this projection is accurate or not will obviously depend on how the expenditure cuts are implemented and whether or not the anticipated revenues materialize. And despite this significant achievement, Latvia will need to enact a further LVL 500 million (USD 1.068 billion) budget adjustment in the 2011 budget, which will be negotiated in the midst of the October 2010 Saeima elections.

#### Minor Protests Accompany Budget Debate

¶4. (SBU) The Latvian Student Association and the Confederation of Trade Unions held back-to-back demonstrations on December 1 to protest various components of the budget. These protests followed a small gathering of motorcycle enthusiasts on November 30 who complained about an increase in the annual motor vehicle fee. These protests were all conducted peacefully and in compliance with government authorities.

#### Economic conditions still weak

¶5. (SBU) In the short-term, the budget passage should remove

international observers' unease about any impending debt default or devaluation and could ease pressure on Latvia's sovereign credit rating. However, the fact remains that the Latvian economy is still contracting, with joblessness rising steadily. Unemployment officially reached almost 15% in November and Eurostat lists the unemployment rate at nearly 20% as of September; the worst in Europe. Some regions (e.g., Rezekne in the east) are experiencing Depression-era official unemployment levels of 25-30%. And the fiscal consolidation, while necessary, will exacerbate the economic downturn. The Governor of the Central Bank has optimistically forecast a return to growth in the second half of 2010 and there is widespread hope that wage and price deflation are helping to restore the country's competitiveness. However, the IMF still believes there will be a 4% drop in economic output in 2010.

16. (SBU) Comment: The resolution of Parex Bank and the implementation of continuing structural reforms are now the keys to economic recovery and the restoration of international financial credibility. Political maneuvering in advance of the 2010 Saeima elections will undoubtedly complicate the 2011 budget discussions. Most Latvian politicians are hoping for an early resumption of economic growth to mitigate the necessity of additional tough fiscal consolidation in an election year. Once the new budget figures have been consolidated by the Saeima Budget Committee and the Ministry of Finance, Post will issue a comparative analytical report of the 2010 budget against the 2009 and 2008 budgets. End Comment.  
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